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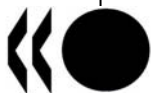
Coping with Labour Shortages: How to bring outsiders back to the labour market

**Ekkehard Ernst**

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**COPING WITH LABOUR SHORTAGES: HOW TO BRING OUTSIDERS BACK TO THE LABOUR MARKET**

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**By**  
**Ekkehard Ernst**

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## ABSTRACT/RESUME

### **Coping with labour shortages: How to bring outsiders back to the labour market**

The Dutch labour market is functioning well, with employment and labour participation rates above OECD averages. Nevertheless, there are sizable pockets of under-activity, including social benefit recipients representing 17% of the working-age population, which could be mobilised in order to address short-run labour shortages and the long-run ageing-related reductions in the labour supply. Reintegrating these benefit recipients would also help to reduce spending on labour market programmes, which is among the highest in the OECD. The paper argues that policies should continue to tackle the high inactivity of these groups. For people on social assistance and older workers, job search requirements should be strengthened and the authorities should continue making the tax-benefit system more work-friendly. For women with low-earning capacities, existing work disincentives should be eliminated. For (partially) disabled people, it is important to envisage labour market re-integration at an early stage. For the long-term unemployed, policies should be further strengthened by adjusting the unemployment benefit and the employment protection systems, as well as further improving current profiling and training measures.

This Working Paper relates to the 2008 Economic Survey of the Netherlands ([www.oecd.org/eco/surveys/netherlands](http://www.oecd.org/eco/surveys/netherlands))

JEL classification: E24; J65; J26; J21

Keywords: Netherlands; labour shortages; inactivity; social assistance disability benefit reforms; unemployment benefits; activation policies; tax-benefit reforms; poverty traps; employment protection legislation.

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### **Remédier aux pénuries de main-d'œuvre : comment réintégrer les travailleurs exclus**

Le marché du travail fonctionne de façon satisfaisante aux Pays-Bas, où les taux d'emploi et d'activité sont supérieurs aux moyennes de l'OCDE. Néanmoins, il existe d'importantes poches de sous-activité, notamment parmi les bénéficiaires de prestations sociales, qui représentent 17 % de la population d'âge actif ; ce groupe pourrait être mobilisé pour remédier aux pénuries de main-d'œuvre à court terme et à la contraction à long terme de l'offre de travail liée au vieillissement démographique. Réinsérer ces titulaires de prestations contribuerait aussi à réduire les dépenses au titre des programmes du marché du travail, qui figurent parmi les plus élevées de la zone OCDE. Nous faisons valoir dans le présent document que les pouvoirs publics devraient poursuivre les efforts déployés pour réduire la forte inactivité de ces groupes. Pour les bénéficiaires de l'aide sociale et les travailleurs âgés, les obligations de recherche d'emploi devraient être renforcées, et les autorités devraient continuer à rendre le système de prélèvements et de prestations plus propice à l'activité. S'agissant des femmes à faible capacité de gain, les désincitations au travail qui influent actuellement sur leurs choix devraient être éliminées. En ce qui concerne les personnes (partiellement) handicapées, il importe d'envisager leur réinsertion rapide sur le marché du travail. Pour les chômeurs de longue durée, il convient de renforcer les politiques en place, en ajustant les systèmes d'indemnisation du chômage et de protection de l'emploi, ainsi qu'en améliorant encore les dispositifs actuels de profilage et de formation.

Ce document de travail est lié à l'*Étude économique* de 2008 consacrée aux Pays-Bas ([www.oecd.org/eco/etudes/paysbas](http://www.oecd.org/eco/etudes/paysbas))

Classification JEL : E24; J65; J26; J21

Mots-clés : Pays-Bas ; pénuries de main-d'œuvre ; inactivité ; aide sociale ; réformes des prestations d'invalidité ; allocations de chômage ; politiques d'activation ; réformes des systèmes de prélèvements et de prestations ; pièges de la pauvreté ; législation sur la protection de l'emploi.

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## **Coping with labour shortages: how to bring outsiders back to the labour market<sup>1</sup>**

**By Ekkehard Ernst**

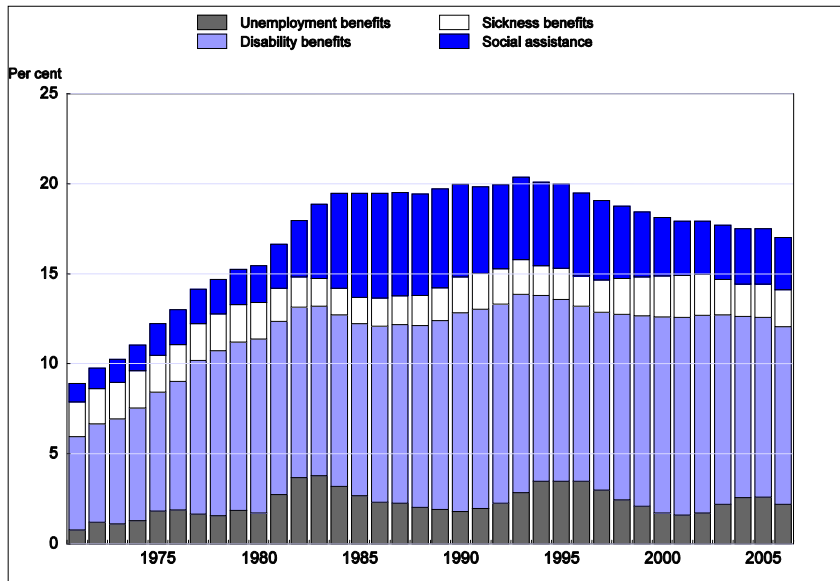
1. Like other OECD countries, the Dutch economy has started to feel the effects of population ageing - older people are exiting the labour market in increasing numbers - weighing down on the growth of labour supply and weakening long-run growth prospects. If this trend persists, there is a risk that the potential supply of labour will stagnate, with detrimental effects on relative living standards. These prospects make it all the more important to mobilise existing pockets of under-activity, which are large by international standards, in particular among groups of social assistance recipients, low-skilled females, disabled people, older workers and the long-term unemployed (Figure 1). Income replacement schemes, targeted to people staying outside the labour market, were initially put in place as an attempt to address the adverse effects of large economic shocks and industrial restructuring, notably in the 1970s and 1980s. High replacement rates and corporatist administration of insurance systems led to a rapid increase in the number of beneficiaries. These schemes were subsequently reformed and inactivity fell rapidly over the 1990s, contributing to an expansion of labour supply. Nevertheless, around 1½ million recipients still access some form of replacement income due to their health characteristics (sick leave, disability benefits), labour market situation (unemployment benefits, social assistance) or age (early retirement). Past efforts to activate these groups have been only partially successful notably because people have moved from one category of inactivity to another, including to long-term unemployment.

2. Bringing outsiders back to employment would go a long way towards addressing the challenges of population ageing. For instance, increasing older workers' participation to Swedish levels could raise the overall labour force participation rate by 4.3 percentage points. Similarly, raising prime-age female participation to the Danish level would lift the overall participation rate by 2.1 percentage points. Together, these would help to overcome the ageing-related reduction in the labour force over the medium-term and would stabilise labour supply in the long run, compared to current levels (Figure 2). Fully exploiting this potential would, however, require activating groups with weak labour market attachment. This is not an easy task, as resuming productive work requires appropriate economic incentives, as well as sometimes new investment in human capital and rebuilding professional skills. The authorities are aware of these challenges and have discussed policy measures at a recent "Participation Summit", which gathered the Dutch social partners and government representatives. In the light of these talks, the present paper discusses measures to improve the work incentives faced by inactive people and to strengthen activation strategies. It reviews successively the situation of social assistance beneficiaries, low-skilled women, disabled persons, older workers and the long-term unemployed. Policy recommendations are summarised at the end of the paper (Box 7).

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1. The author is an economist working in the Economics Department of the OECD. The paper is based on work originally prepared for the Economic Survey of the Netherlands published in February 2008 under the authority of the Economic and Development Review Committee (EDRC). Special thanks go to the Dutch Delegation to the OECD and CENTre at the University of Tilburg for having generously granted access to the Dutch Household Panel in preparing the calibration of the model. The author would also like to thank Jens Høj, Patrick Lenain, Andrew Dean and Val Koromzay for comments on earlier drafts, as well as Laure Meuro for technical assistance and Heloise Wickramanayake and Deirdre Claassen for technical preparation.

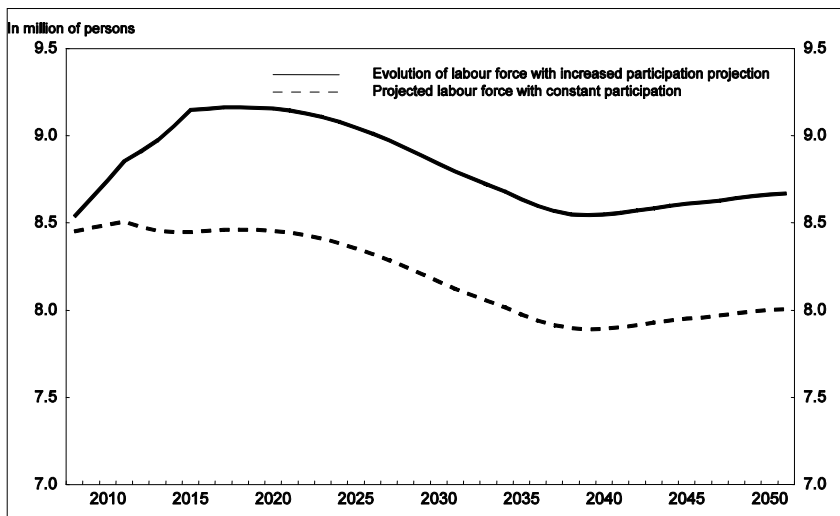
**Figure 1. Incidence of inactivity remains large<sup>1</sup>**



1. In percent of working-age population

Source: CPB, 2007.

**Figure 2. Labour force projections: current projections vs. projections with increased labour participation<sup>1</sup>**



1. The chart shows the evolution of the projected labour force both with current labour force participation projections and with increased labour force participation projections. The projected participation increase has been assumed to take place at an annual rate of 2% to reach a participation rate of 83% (similar to Sweden) in 2014.

Source: CPB, Secretariat's calculations.

### Activating social assistance beneficiaries

3. Like most other countries, the Netherlands has a social assistance scheme providing support to people with insufficient financial resources to meet their essential living costs. The Work and Benefit Act (WWB) requires that people take on employment to support themselves, but provides a topping-up benefit

to those who are unable to earn enough. The Act ensures that everyone receives at least the national assistance level, set at EUR 865.80 per month for a single person (EUR 618.43 per month for those who share their rents) and EUR 1 236.86 per month for a couple as of 1 January 2004.<sup>1</sup> The budgetary and implementation responsibilities of the scheme were transferred to the municipalities in 2004 (apart from the establishment of benefit levels, which remains centralised). In addition, it was decided that the municipalities could use budget surpluses in this area for other purposes, thus enhancing the financial incentives for municipalities to monitor and activate benefit recipients.

4. There has been a decline in the number of persons receiving social assistance benefits since the 1990s, including during the most recent period, but the proportion of recipients in the labour force remains high by international standards (Table 1). Although the stronger economic situation has undoubtedly played an important role, it is widely acknowledged that the new incentive structure has stimulated municipalities to become more effective in screening new applicants and activating benefit recipients. Various tools have been used to enhance the incentives for job-search and help the labour market reintegration of recipients. The gate-keeper functions have been strengthened, so as to encourage applicants to accept temporary jobs or go back to schooling, rather than enrol under the scheme. A “work-first” strategy has been widely adopted by municipalities, whereby the benefit claimants are put in a job or training programme from day one, which seems to have been especially effective. As well, municipalities have the possibility to allow benefit recipients to combine work-related income and out-of-work benefits and to grant “back-to-work bonuses” in case of successful job finding.

**Table 1. Social assistance in the OECD**  
Beneficiaries in percent of the working-age population

Type of programme	1990	1995	2000	2004
Australia Lone parent	2.2	2.7	3.1	3.3
Canada Social assistance	2.1	2.9	1.7	...
Denmark Social assistance	3.3	2.9	2.5	...
Finland Social assistance	0.4	0.3	0.4	0.3
France Social assistance	1.7	2.9	3.2	3.4
Germany Social assistance	2.1	2.2	2.2	2.5
Ireland Lone parent	1.6	2.7	3.4	3.3
Japan Social assistance	0.3	0.3	0.3	0.4
<b>Netherlands Social assistance</b>	<b>5.1</b>	<b>4.7</b>	<b>3.2</b>	<b>3.1</b>
New Zealand Lone parent	4.3	4.3	4.3	4.1
Norway Social assistance	2.6	3.4	2.6	2.2
Portugal Social assistance	...	...	7.3	...
Spain Social assistance	0.0	0.2	0.3	0.3
Sweden Social assistance	1.3	2.1	1.9	1.7
United Kingdom Lone parent	2.2	2.9	2.4	2.0
United States Lone parent	2.3	2.5	0.9	0.6

*Note:* Non-categorical social assistance is not available in all OECD countries and is often substituted for by income support for people with weak earnings capacity and children.

*Source:* Carcillo and Grubb, 2006

5. While the success of the reform should encourage other OECD countries to implement similar measures, the incentives to return to work could be strengthened further, in particular to avoid a new stock of recipients from building up in an economic downturn. In this context, current plans to exempt lone parents with children under the age of 5 years from job-search requirements appear to go in the wrong direction.<sup>2</sup> Under these new plans, such persons would still be obliged to participate in training schemes to prepare for future labour market participation, but they would not be expected to work immediately. Such a measure is unlikely to have the intended effect and would be more costly than immediate participation on the labour market with support provided in the form of guaranteed child care.



### Tax measures that discourage low-skilled women from working

6. Despite high female participation rates at the aggregate level, low-skilled women tend to remain at the margin of the labour market. This is particularly so for married low-skilled women, who are discouraged from participating by the tax system, even though they would like to work and there is a strong demand for their labour, particularly in the service sector (Jaumotte, 2003). Policies have focussed in the past on removing impediments to full-time work, such as raising the provision and subsidisation of childcare services, but disincentives remain.

7. A tax measure particularly hampering female participation is the transferability of the general tax credit. Although the Dutch tax system has largely been individualised, the general tax credit of non-participating partners is transferable within couples, for taxpayers with low to moderate incomes. This increases the effective tax rate at the participation margin for the second earner, creating inactivity traps that cause women, especially low-skilled women, to stay at the fringe of the labour market. According to OECD estimates, reducing marginal effective tax rates of the low-wage second earner to the same level as for the first earner would increase the female participation rate by 2.4 percentage points (Burniaux, Duval and Jaumotte, 2004). In its coalition agreement, the Dutch government has recognised this transferability of the tax credit as a problem for female participation and decided to individualise it, thus making work pay more for low-skilled women. The phase-out of transferability will, however, take place over a period of 15 years, which seems unduly long. In addition, the phase-out will only apply to taxpayers born after 1971 and mothers with children under the age of 6 years will be exempted, limiting the overall impact of this policy change. Given the important effect of a full phase-out, which is estimated to increase overall female labour participation by 6.6 percentage points (Table 2), the transferability should be eliminated more rapidly and without exemptions.

**Table 2. Long-run impact of an individualisation of the tax credit on labour supply**  
(In per cent, unless otherwise indicated)

Labour supply in total hours worked	1.0
Primary earners	0.1
Secondary earners	4.8
Single persons	0.4
Female participation rate (percentage points)	6.6
Employment	
Low skilled	0.7
High skilled	1.3
Unemployment (percentage points)	
Low skilled	0.1
High skilled	0.1

Source: De Mooij, 2006 and Secretariat's calculations.

8. Unconditional child benefits and the income-tested child tax credit discourage participation, in particular of lower-income women (OECD, 2006a, p. 130). Currently, the unconditional child benefit per child is EUR 1087 *per annum*.<sup>3</sup> The income effect of granting unconditional child benefits provides incentives for low-income mothers to withdraw completely from the labour market. In addition, households are eligible for a child tax credit of up to EUR 939.<sup>4</sup> On the other hand, a small individual child credit (combination credit) of EUR 146 and an additional child credit for second earners, of EUR 700, are in place in order to stimulate women to combine work and child care activities. According to CPB calculations (Table 3.3) either a fully individualised targeted child tax credit for parents with a low income (column 3) or a child tax credit targeted specifically at the second earner (column 4) could increase female participation by 1.2%. As the latter measure is better targeted, the distortions imposed on other groups as a result of the increased financing burden would be less severe. Following this analysis, the government has

decided to make the additional tax credit for second earners income dependent (with no phase out) and to increase its maximum amount. In order to further stimulate female participation, the authorities should consider shifting more of the family-income based child tax credit to the individual or second earner children tax credit.

**Table 3. Long-run impact of reforms in child allowances on labour supply**

	General child allowance	Child credit for low incomes	Child credit for working couples
Labour supply in total hours worked	-0.4	-0.4	0.1
Primary earners	-0.3	-0.4	-0.1
Secondary earners	-0.6	0.0	1.0
Single persons	-0.4	-0.3	-0.1
Female participation rate (percentage points)	-0.5	1.2	1.2
Employment			
Low skilled	0.1	0.5	0.3
High skilled	-0.7	-0.9	0.1
Unemployment (percentage points)			
Low skilled	-0.1	0.0	-0.1
High skilled	0.0	0.0	0.0

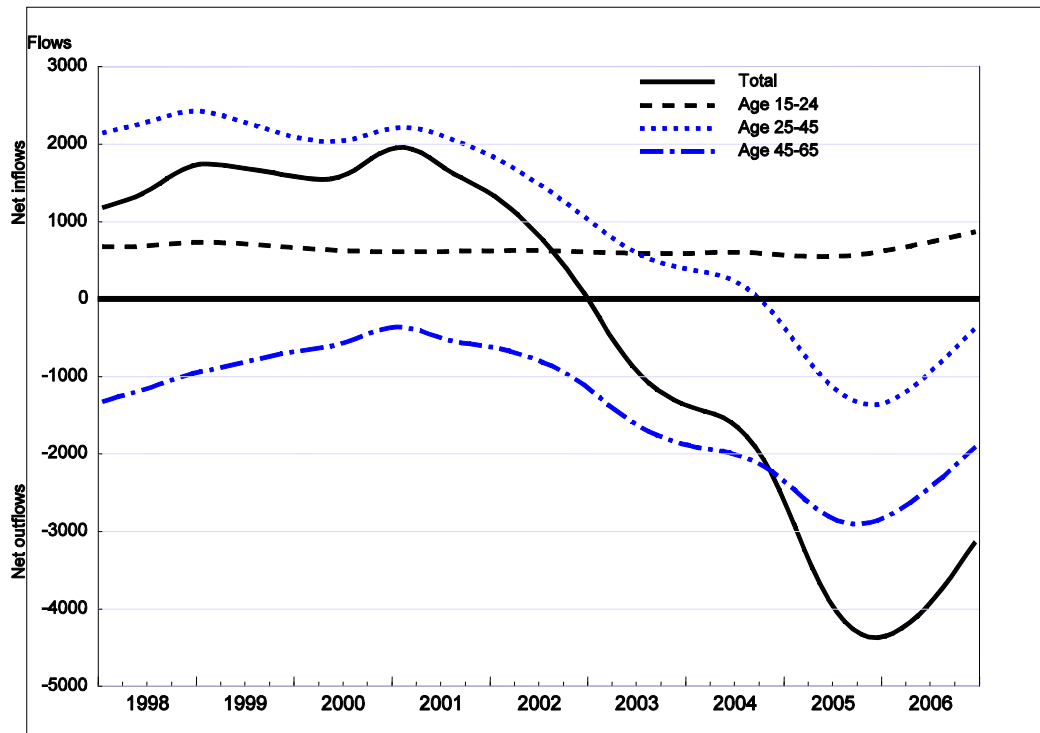
Note: Changes are measured in per cent if not otherwise indicated

Source: De Mooij, 2006.

### Reforms of disability benefits

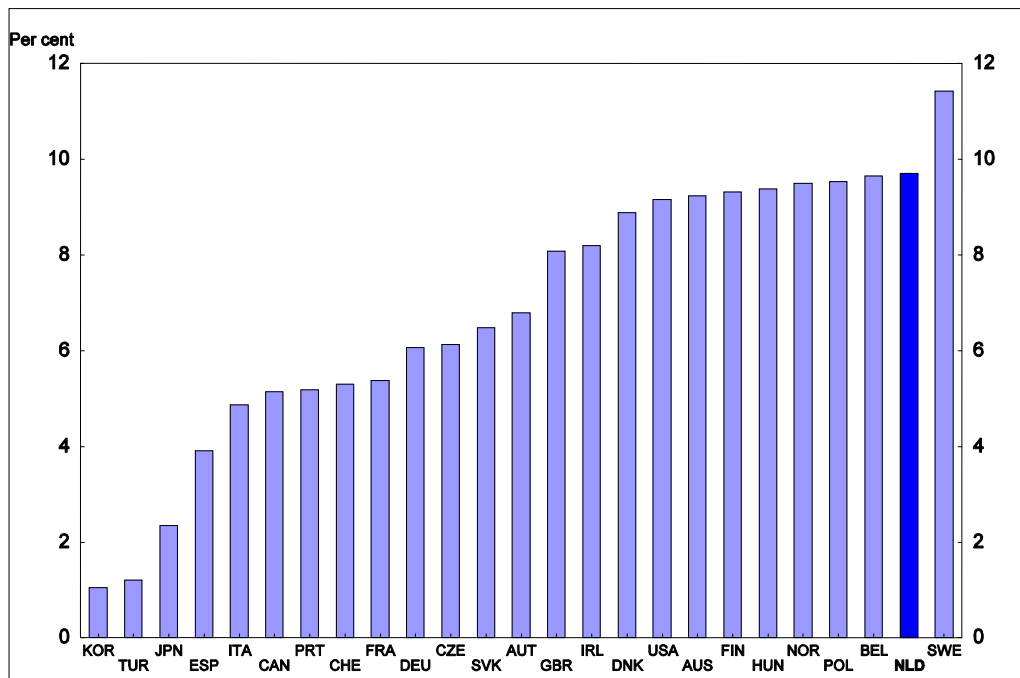
9. Several reforms introduced since the 1990s have successfully reduced the inflow into the disability benefit (DB) scheme, notably the Gatekeeper Act in 2002, the application of tighter testing criteria in 2004, and the Labour Capacity Act in 2006. Entry into the disability benefit programme is now subject to more rigorous medical tests, and there is a required sickness absence period of two years paid by the employer. As a consequence, inflows into the DB scheme have decelerated substantially, while gross outflows continue at a much higher rate, leading to a net outflow of recipients from the system (Figure 3).<sup>5</sup> Nevertheless, the number of DB beneficiaries remains high in international comparison, mainly due to a high incidence of partial disability (Figure 4). Moreover, the decline of inflows into the DB scheme has been concentrated in the age group 25-45. For the disabled of both older and younger age groups, less progress has been achieved in activating and partially reintegrating the benefit recipients into the labour market. Finally, little is known about where those who have left the DB scheme have moved to; in particular, no structural assessment of labour market reintegration is available, making it difficult to evaluate the success of the DB reform for raising labour supply.

Figure 3. Net flows in and out of the disability benefit scheme, 1998-2006



Source: Statistics Netherlands.

Figure 4. Incidence of disability in the OECD  
Per cent of population aged 20-65 years, 2003-2004<sup>1</sup>



1. 2003 for the Czech Republic, Finland, France, Germany and Italy.

Source: OECD, Going for growth, 2006.

10. Medical reassessment and stricter access criteria of newly disabled workers have helped to bring down the aggregate rate of (partial) disability. However, most of those formerly classified as disabled have been out of the labour force for too long to be quickly returned to employment. It is, therefore, essential for this group to receive early activation and re-integration services. New entrants may even receive activation during their period of sickness leave if their current employer cannot offer suitable alternative occupations with the firm. In this regard, the government enacted several measures to strengthen work incentives and to facilitate reintegration of currently partially disabled people (Box 1), some of which having been further developed after the recent Participation Summit. Incentives to take up work after entering the partial DB scheme could be strengthened even further if the initial period during which benefits are based on previous earnings unrelated to the remaining partial work capacity, would be limited further, or phased-out altogether. Despite current difficulties in increasing participation of partially disabled workers more forcefully, regular assessments remain essential. In this respect, the recent decision to lower the maximum age at which beneficiaries under the old scheme are subject to the new, stricter medical testing criteria from 50 to 45, is unfortunate. This group remains, however, liable to periodic medical reassessment under the old criteria. Only new cases above 45 will be tested and reassessed under the new, stricter medical testing criteria. Medical and technological innovations may offer new opportunities to participate – at least partially – in the labour market and hence lower inactivity among DB recipients.

**Box 1. Reforms to strengthen work incentives for partially-disabled people**

The government enacted a series of measures in order to ensure that the DB reform leads to an overall reduction in the stock of inactive people, and not only to a transfer from one benefit scheme to another. In particular, reintegration incentives have been strengthened through:

- an extension from one to two years of the initial sick leave period to be covered by the firm, which increased incentives for employers to find alternative job opportunities within the firm;
- the introduction of a “no-risk policy” whereby the UWV (*uitvoeringsinstituut werknemersverzekeringen*) covers sickness payments for employers who keep a (partially) disabled employee at work in case this person becomes sick again within five years;
- strengthening the incentives to take up work by introducing DB replacement rates that are dependent on the hypothetical earnings capacity of the benefit recipient. Upon entering the WGA scheme, those who have worked during 26 out of the last 36 weeks receive a replacement income (the *loongerelateerde uitkering*) that covers 70% of the difference between the current and the last wage (up to a ceiling). This benefit runs out after an age-dependent period of a maximum of 5 years, after which it is replaced by the *loonaanvullingsuitkering*, which is set as a function of the former wage and the hypothetical wage that the disabled person may still be able to achieve, if a person earns at least 50% of his hypothetical wage. Otherwise, the benefit is replaced by a *vervolguitkering*, which is based on the minimum wage.

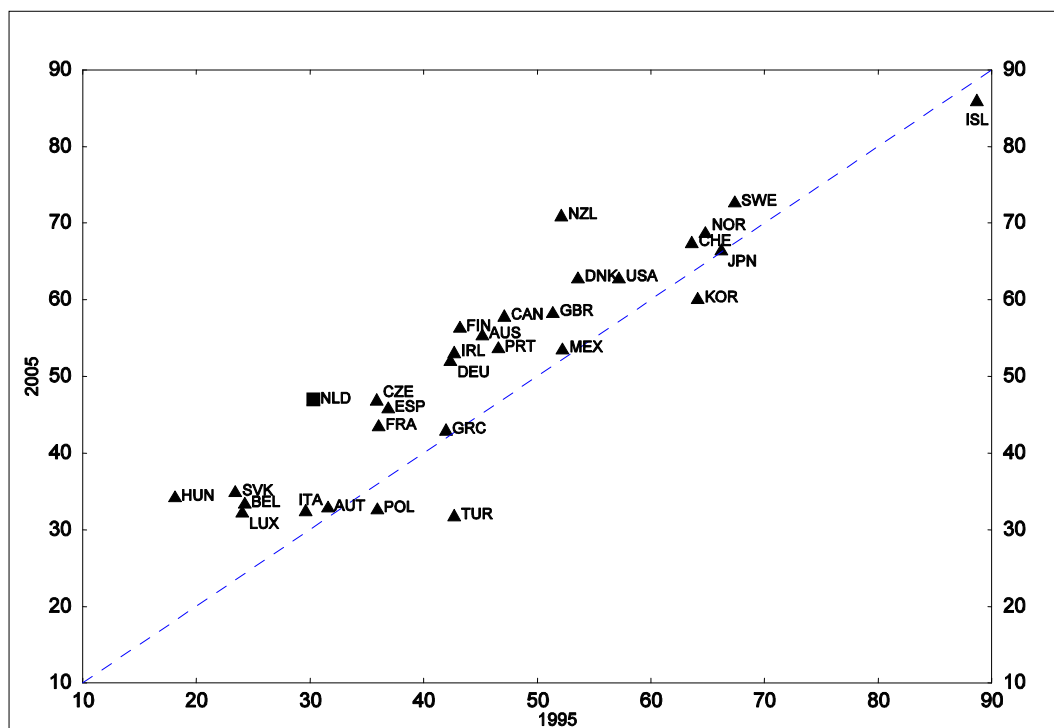
11. There has been a sharp increase in the number of younger people entering into disability under the *Wajong* scheme (mostly younger people with unspecified psychological disorders). The stock of recipients increased from 1.5% to 1.9% of the labour force during the last seven years. The *Wajong* scheme does not offer similar incentives (including reintegration services) as the DB system for prime-age workers, so recipients run the risk of permanently failing to integrate into the labour market. At the same time, weak activation and few medical reassessments of *Wajong* beneficiaries seem to have encouraged young people with lower educational backgrounds to apply for these benefits. The government should consider reacting quickly to signs of further inflows by adjusting its medical access criteria for certain types of disability. Moreover, incentives for the UWV to bring these people into employment (and off the benefits) are low as they usually lack labour market experience and may require the heavy use of reintegration services. In its current discussions on the reform of the *Wajong* scheme, the government

should therefore include improving the incentives for school-to-work transition of younger people by requiring (except in cases where the impossibility of ever being able to work is obvious), that those who register under the *Wajong* scheme first apply for Social Assistance benefits and be available for activation measures and job market integration before they qualify for disability benefits.<sup>6</sup>

**Continued work at older age**

12. The participation of older workers in the labour market is still low in international comparison (Figure 5) though it has increased substantially in recent years, in particular among the age group 55- 59, reflecting the removal of tax incentives for early retirement (Table 4).<sup>7</sup> Adding to this effect is the complete elimination of pre-pension schemes, which increased the effective age of retirement. Moreover, as the removal of remaining tax incentives for early retirement schemes only applies to new retirees and a transition scheme has been put in place for those who turned 55 before 1 January 2005, a further increase of participation and employment rates for the elderly above 60 years can be expected. To further stimulate participation of the elderly the government plans to increase the work-related tax credit for workers that continue working after 62 and until retirement.

**Figure 5. Old-age participation rates in the OECD**  
(1995 vs. 2005)



Source: OECD, Labour Force Statistics.

**Table 4. Participation of older workers**

(In % of the working-age population)

	1995	2000	2005	2006
<b>Men and women</b>				
55-59	39.1	48.9	55.4	58.1
60-64	11.2	15.5	18.3	20.8
Total 55-64	25.8	33.6	39.7	41.7
Total 15-64	57.8	64.5	63.2	64.5
<b>Men</b>				
55-59	57.5	66.8	72.2	73.2
60-64	17.6	23.9	25.1	28.8
Total 55-64	38.8	47.4	52.3	53.8
Total 15-64	71.6	76.6	72.1	73.1
<b>Women</b>				
55-59	20.4	30.5	38.3	42.7
60-64	5.1	7.3	11.5	12.8
Total 55-64	13	18.8	26.9	29.5
Total 15-64	43.5	52	54.1	55.8

Source: Statistics Netherlands

13. Still, continued work at an older age is discouraged by several factors. Although older unemployed people have been subject to job-search requirements since 2004, and the duration of employment benefits has been shortened, the maximum duration of unemployment benefits is still long and unemployment can be used as a transition to retirement. Severance payments can be high after long tenure (as a rule they are equivalent to 1 month of salary per year of service, until the age of 40; after that, each year accounts for 1½ months salary until the age of 50, thereafter, each year worked accounts for 2 months of salary). These severance payments can be used to top-up unemployment benefits. Furthermore, workers are often not able to keep working after the age of 65. In most cases labour contracts legally end at 65 by collective agreement. Even for those not covered by collective agreements, the strict employment protection - and hence the obligation to pay high severance payments - stops at the 65<sup>th</sup> birthday.<sup>8</sup> In addition, the obligation to pay wages for the first two years of sickness also applies to employees above 65 years of age, which private insurers are hesitant to insure. Combined together these features provide strong incentive for employers to lay off their workers on this particular birthday. In order to strengthen labour demand for older workers after their 65<sup>th</sup> birthday, the government should consider abolishing the requirement to pay wages during long periods of sickness leave for workers above the age of 65. Finally, participation incentives for older workers could also be strengthened by indexing the official retirement age to life expectancy, thus further edging up the effective exit age from the labour market.

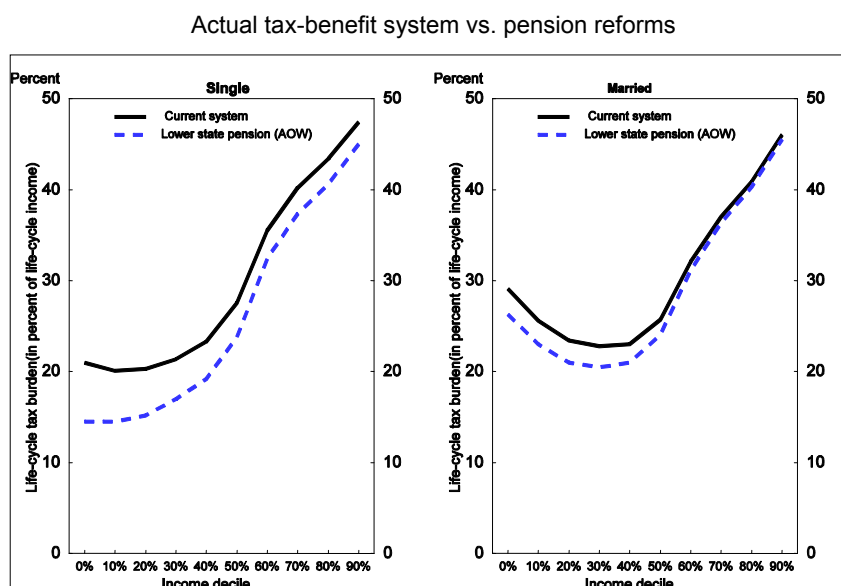
14. Existing tax-favoured savings schemes create an additional hurdle to old-age labour participation. Currently, employees have the choice between a general tax-favoured savings scheme (*sparloonregeling*) and a competing life-course savings scheme (*levensloopregeling*) that is set up explicitly to finance a temporary withdrawal from the labour market (Box 2). The latter plan is particularly popular among older workers, but in principle both plans can be used to finance early retirement before the age of 65.<sup>9</sup> In order to stimulate a further rise in the effective exit age from the labour market, the government should eliminate the possibility of using this tax exemption to finance early exit from the labour market. If the government considers that the current tax system unduly discourages the accumulation of savings with potentially useful externalities (such as to finance periods of retraining or pay for the education of children), it could consider raising the level above which financial assets are subject to the 1.2% wealth tax to, say, EUR 100 000, rather than grant tax exemptions targeted to specific schemes, such as life-course savings.<sup>10</sup> This would not only reduce possible distortions in the allocation of savings, but also reduce administrative complexity.

### Box 2. The life-course savings scheme

As part of the tripartite agreement to phase-out tax advantages favouring early retirement systems, it was agreed to introduce a life-course savings plan (*levensloopregeling*, LCS) to allow employees to save part of their income in a fund out of which, a period of up to 3 years of labour market withdrawal can be financed (early retirement, sabbaticals, paternity leave or other family obligations, training and educational leave). A maximum of 12% of the gross wage can be deducted annually from the taxable income so as to build savings, subject to a total accumulated saving ceiling of 210% of the gross wage. Taxation on such saving is deferred until the fund is drawn down. Due to the progressivity of the tax system, this can generate a substantial tax advantage, in particular in higher income brackets. A further tax incentive stems from the exemption of the life-course savings from the net wealth tax, which equals 1.2% and is applicable to most other financial assets. Moreover, for each year of participation in the scheme, the holder of the fund is entitled to a fixed tax credit. When the fund holder reaches the official retirement age at 65, the fund can be transferred (without the tax credit) to second pillar pensions, thereby increasing taxable income and raising the implicit tax on continued work.

Currently, with the system entering only its second year, the inflow into this new savings scheme has been limited as savers have to choose between the LCS and the older, tax-favoured savings scheme (*spaarloonregeling*), although the system is expected to continue maturing. However, the system experiences a relative success among older workers. Moreover, in contrast to the original intention to allow employees to adjust their labour supply to their personal circumstances at any point during their working life, a recent survey reveals that savers currently intend to use the plan to retire earlier.

15. A Beveridge-style state pensions system (AOW) provides an old-age pension income to people who are aged 65 and over and have lived in the Netherlands for most of their lifetime,<sup>11</sup> irrespective of past contributions, similarly to the scheme in place in New Zealand. Eligible single pensioners receive a first pillar monthly pension of EUR 956.18 and retired couples receive EUR 1609.91. This AOW pension constitutes a social safety net and represents 34% of pensioners' average earnings (OECD, 2006b). Such a system runs the risk of weakening labour participation incentives, in particular for low-income and second earners, as inactivity does not penalise access to the AOW pensions. The government should consider reforming the current state pension system in order to strengthen the participation incentives. The WWB Act already provides a social safety net ensuring a net minimum income to every resident, including pensioners. A separate social safety net therefore does not appear necessary. For people with life-time careers, the well-functioning second pillar pension funds provide adequate old-age retirement income. A reduction in the AOW pension is likely to increase participation through postponed (early) retirement, without aggravating poverty among pensioners (Bruinshoofd and Grob, 2006). More generally, a budget-neutral reduction of both the pension entitlement and income tax rates would substantially reduce the net present value of the tax burden over the working life, in particular for lower-income earners (Figure 6). For instance, a reduction in the replacement rate from 30% to 25% would help to increase labour participation, in particular of the 55-65 age group, by 3% and the average working time for this age group by almost 10% (Box 3). Any changes to the pensions system, however, should be introduced gradually in order to allow future recipients to make alternative savings.<sup>12</sup>

**Figure 6. Net present value of tax liabilities when lowering state pension<sup>1</sup>**

1. The figures present the average life-cycle tax burden across income deciles in the current system, compared with the life-cycle tax burden after a reduction of the gross state pension of EUR 161 per month.

Source: Secretariat's calculations.

### Box 3. Simulations of pension system reforms

Reforms in the public and private pension systems involve changes in participation incentives over the life-cycle. In order to simulate such effects, an overlapping-generations model has been estimated and calibrated for 10-income deciles of the Dutch economy, similar to the approach used by Kotlikoff and Rapsajn (2006). On the basis of the current tax-benefit system, the model produces a labour force participation rate of 75.8% and a supply of working hours of around 32 hours a week, matching the observed values (see Ernst and Teuber, 2008 for details on the model and its results).

The model considers the impact of three different types of taxes on incentives to participate and to expand working hours: taxes on consumption, on labour earnings and on capital income. In addition, the model introduces various social benefits and tax breaks available to households, including the general tax credit and tax exemptions for pensioners. The equilibrium distribution of the aggregate capital stock across different households then allows to calculate the net present value of tax liabilities (presented in the text) that a household in a certain income bracket faces.

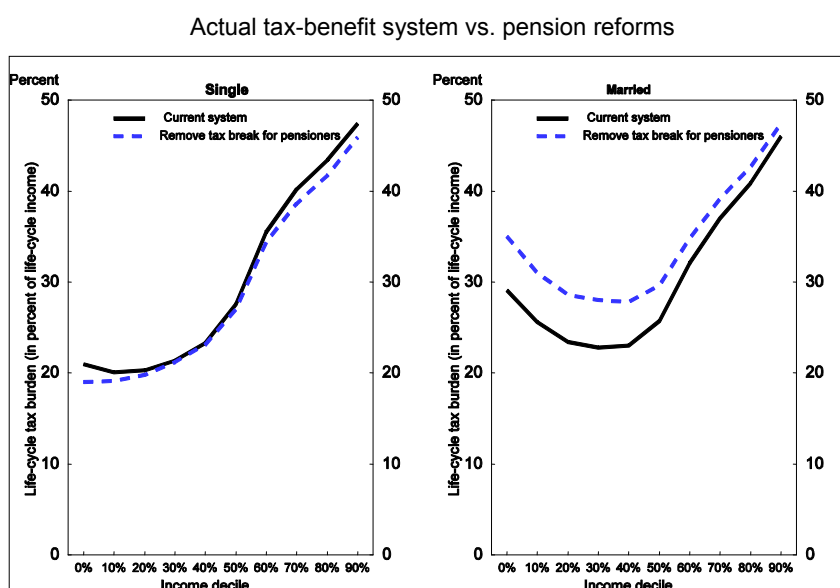
When simulating the reforms to the pension system, a balanced-budget rule has been imposed: additional budgetary resources made available by lowering replacement rates or raising the marginal tax rates of pensioners are redistributed to households via lower consumption taxes. Alternatively, this higher primary surplus could have been given back to households in the form of lower marginal income tax rates, thereby possibly even increasing the beneficial effects presented above.

16. Incentives to postpone retirement are also affected by the fact that pensioners do not pay social security contributions for state pensions. This tax exemption allows a reduction in the tax rate of 17.9 percentage points for all income in the first two income tax brackets, implying an increasing implicit tax on continued work before the age of 65. In addition, the exemption constitutes a substantial redistribution towards pensioners of about 0.5% of GDP (Stevens, 2005). As first pillar pensions are linked on a net basis to the social minimum income, a removal of this tax exemption would increase state pensions on a gross basis, yielding the same net disposable income as before. Consequently, the current tax



break exclusively benefits pensioners who also have access to second pillar pensions (van Ewijk, 2004). Hence, removing the tax break would not lower net disposable income for pensioners who only receive the first pillar pension but would raise the tax burden for those who also have access to second pillar pensions. The government currently plans to strengthen participation incentives for older workers above a certain income level by introducing a new levy that reduces the value of the tax break for those who stopped working before the age of 65. While this measure is welcome, its contribution to long-term fiscal sustainability will be small and the impact on labour participation limited as life-cycle tax liabilities do not substantially decline (they even increase for married earners, see Figure 7). The full impact of removing the tax break depends on how the additional tax revenues will be used to strengthen participation incentives for the working-age population.

**Figure 7. Net present value of tax liabilities when removing pensioners' tax exemptions<sup>1</sup>**



1. The figures present the average life-cycle tax burden across income deciles in the current system, compared with the life-cycle tax burden when removing the tax exemption for pensioners on the first and second income bracket.

Source: Secretariat's calculations.

### Activating the unemployed

17. Despite favourable employment trends, long-term unemployment remains high in comparison to countries with a similarly low overall rate of unemployment. This may be related to the transfer of persons from the above-mentioned categories to the pool of the unemployed, following their activation, immediately or after a short period of work. Long spells of unemployment discourage job search efforts, and encourage the unemployed to eventually withdraw from the labour market altogether. The employability of workers diminishes rapidly in the early months of unemployment (Lechner and Vazquez-Alvarez, 2006). Thus, activation and reintegration are essential at an early stage particularly to off-set declining search activity.

18. The duration of unemployment benefits was reduced from 5 years to a maximum of 38 months at the end of 2006, in an attempt to increase job search incentives. Nevertheless, benefit duration remains long in international comparison. Moreover, income replacement rates do not decrease much with the length of the unemployment spell, even though they are initially at similar levels as in other OECD countries. Declining replacement rates have been shown to be an effective tool to strengthen job search

incentives and to prevent unemployment from becoming structural, in particular when benefit duration is long (Bassanini and Duval, 2006). Hence, although unemployment benefits contribute to improving the quality of job matches (OECD, 2007), the combination of long duration and non-decreasing benefits is likely to dampen incentives for job search. The government should therefore consider shortening the pay-out period of unemployment benefits further, possibly to a period of 2 years, as in other countries. In addition, net replacement rates should decline with the length of the unemployment spell. A consequence of phasing down benefits could be that the initial replacement rate would be increased in order to provide a sufficient margin for a steeper taper rate.

### ***Reforming severance payments***

19. Long-term unemployment is also likely to be raised by employment protection, which is strict in international comparison, thus reducing labour market turnover and prolonging unemployment spells for those at the margin of the labour market (Lalive *et al.* 2004). Under current procedures, firms face a dual dismissal system (Box 4). Smaller enterprises usually choose the administrative route, which avoids the payment of severance payments, but has the disadvantages of being lengthy and not always successful. Larger employers prefer the judicial route, which is generally quicker and less uncertain, but comes at an important financial cost in terms of severance payments. As a rule, these severance payments are based on the seniority of the employee (see above).

#### **Box 4. The dual system of the Dutch dismissal law**

Lay-offs can occur through two channels: 1) employers can address their request to the local public employment service (CWI) to obtain prior permission or 2) they can request a local court to dissolve the individual employment contract. In the first case, employers are faced with long notice periods (depending on the tenure of the employee) and a more bureaucratic and time-consuming dismissal procedure. The second route is faster, but also more expensive as firms are faced with much higher severance pay obligations, especially for long job tenures. Nevertheless, this route has increasingly been taken, in particular by large companies, as the costs for an individual layoff rapidly declines relative to the CWI-route when the salary of the person concerned increases, as it usually does with the size of the company (SER, 2005).

20. After a recent Participation Summit, the cabinet had put forward a proposal to review the current dismissal system and replace it with a more predictable scheme, which would regulate the level of severance payments. The new system would have specified severance payments in law and allow appeal of dismissals to local courts only as an *ex post* option, in case one of the parties is unfairly treated. This proposal would have made court decisions, and hence the level of severance payments, more predictable. The social partners failed to unanimously endorse this proposal, and the Cabinet finally decided not to pursue the reform of the dismissal law for now, but to establish a commission to advice on how to raise participation. However, the proposed reform would have been a welcome initiative to decrease the procedural inconveniences of the current system. The authorities should continue to assess the possibilities to reform the dismissal law. In a new proposal, the authorities should consider to limit the maximum amount of severance payments that seemed to be high in the earlier proposal, as it could have reached up to EUR 100 000 for older workers with long job tenure and even more for workers with annual incomes above this level,<sup>13</sup> which constitutes a serious financial risk, in particular for smaller companies.<sup>14</sup> Instead, the government should aim at legislating a minimum amount of severance payments - possibly dependent on the job tenure – that is well below proposed levels, leaving it up to social partners to negotiate any additional severance payments. This would help to reflect better sectoral and individual differences in the willingness of firms to grant severance payments to their employees. Moreover, the current proposal suggests letting rights to severance payments accumulate at a faster rate for workers above 50 years. This is likely to decrease employment chances for older workers and the government should aim at aligning severance payments rights between different categories of workers. The dismissal reform could also take

example at the Austrian severance payment system, in particular as regards the objective to lower payments for dismissed workers with long seniority (see Box 5).

#### **Box 5. Reform of the system of severance payments in Austria**

The Austrian dismissal system used to share aspects found in the Dutch system, particularly the reliance on court decisions. The system was reformed in 2003 in order to address concerns about the lack of flexibility and for equity reasons (only 1/3 of all employees benefited from severance payments). The reform aimed, in particular, at lowering firms' financial burden of dismissals and at limiting the additional costs resulting from an extension of the system to small- and medium-sized enterprises, which effectively had not been subject to the earlier severance payment scheme.

As a result, individual savings accounts have been opened for each new employment contract signed after January 2003, managed by one of nine privately run funds. Under the new system, employers are obliged to contribute 1.53% of gross monthly salary to these accounts. The rate was set such as to guarantee 12 months pay after 37.5 years of contributions, although there are signs that the rate is set too low. Contributions to the fund are tax free, but withdrawals are subject to a 6% flat rate. Dismissed employees can draw on their individual accounts, provided that they have been with their former employer for at least three years. Voluntary quits and dismissals after shorter tenures are not covered but the accumulated fund remains in the individual account, which can be taken over to the next employer. Any accumulated fund can be accessed at the legal retirement age or after five years of quitting the labour market (for instance, for child caring or expatriation).

The new system is claimed to have enhanced job mobility, lowered dismissal costs and reduced litigation over unfair dismissals. However, job mobility is mainly enhanced from the point of view of employees who no longer face loss of accumulated rights to severance payments when switching jobs. For employers, the new system mainly removes the liquidity risk of severance payment obligations during economically difficult times without reducing the overall financial burden of the system. Dismissal rates are unaffected, as the contribution rate is not linked to the number of lay-offs (such as with unemployment benefit experience rating in the US). What is more, the higher non-wage costs resulting from severance payments are likely to be internalised over time, except for employees at the minimum wage. The system resembles a savings device but with limited competition between the nine severance funds as the employers choose for the employees in which fund they accumulate the severance payment rights.

#### ***Enhancing activation schemes***

21. Activation schemes have experienced some streamlining recently (see Box 6) but further improvements of activation schemes would help stimulating additional outflows from the unemployment pool and reduce the incentives of long-term unemployment (Boone and van Ours, 2004). Job search assistance is provided by the CWI (*Center for werk en inkomen*), which acts as a gatekeeper by placing the newly registered unemployed into different activation categories, depending on the perceived risk of long-term unemployment. The UWV, on the other hand, administers the earnings-related unemployment insurance benefits, activates long term unemployed and applies sanctions in case of insufficient job search efforts.

### Box 6. Recent developments in activation policies

In order to place the newly unemployed into different activation programmes, the CWI used to establish a profile of the job seeker on the basis of a point system (called the “chance-meter”) reflecting the job seeker’s difficulties to reintegrate into employment. Each of the four profiles was characterised by a particular activation strategy and certain reintegration programmes to which the job seeker had access; however, once placed in a certain category, a job seeker only had access to programmes belonging to his or her particular profile, even if some other programmes may have been more appropriate. Similar profiling systems are in place in other OECD countries to avoid using expensive active labour market measures for the easy-to-place unemployed (Frölich *et al.*, 2003). However, there was and continues to be scope for improving the system as the predicted time of exit from unemployment was properly assessed in only 60% of all cases. The implication was that too many unemployed were left alone for too long without proper activation and that there was too much spending for those who turned out to find a new job more easily (Tergeist and Grubb, 2006). In addition, reflecting the lack of full integration of employment services provided by the CWI, the UWV and the municipalities, the latter two institutions carry out their own profiling of job seekers into target groups that are contracted out to private replacement providers, creating substantial administrative overlays. In order to reduce this administrative burden and in an attempt to improve the accuracy of the profiling, the government has consequently reduced the number of profiles from four to two.

22. The current profiling system employs only two profiles whereby everyone is deemed capable of seeking for a job (stream A) unless there is a situation where individual characteristics prevent immediate job seeking (stream B) which (temporarily) hinders job search activities. Job-seekers in stream B generally need special reintegration programmes that focus on removing obstacles and restoring their daily life. The need for profiling may be reduced when there are economic incentives for the unemployed to self-select into different activation groups. This could be achieved, for instance, by offering two different forms of unemployment benefits and assistance. An unemployed person could choose a combination of minimal monitoring of job search efforts and relatively high, but steeply declining unemployment benefits, or the person could choose a package with lower, but less rapidly declining unemployment benefits, combined with tight job search controls and stiff sanctions. This would allow the unemployed to reveal their own assessment of reintegration chances and support the CWI in properly targeting reintegration measures.

23. International evidence suggests that profiling may not be sufficient for activation measures to be successfully applied, and should be replaced by selecting activation programmes according to their success in bringing individual job seekers back into employment (Frölich *et al.* 2003). This implies that, for each job seeker, all available programmes are initially considered and only those programmes are applied that promise to generate the highest individual chance of return to employment. An advantage of this approach is that it avoids excluding job seekers from certain programmes that belong to a different activation category, even though they may be more appropriate in the individual case. The current profiling system goes a long way in following this approach. Nevertheless, the government should consider abolishing profiling altogether and moving instead towards a full targeting system in order to reduce misclassification.

24. Most job placement and reintegration services are delivered by private providers as the result of the SUWI Act compelling the UWV to rely on outplacement.<sup>15</sup> The introduction of this quasi-market for reintegration services has helped to reduce the stock of unemployment and social assistance beneficiaries in a cost-efficient way. Nevertheless, further improvements of the quality of reintegration service are possible (Box 7). First, part of the tendering process is organised at the level of the 467 municipalities, and there are no clear performance ratings, contributing to a lack of transparency and the risk that some of these municipalities may get stuck with a “preferred” provider (Tergeist and Grubb, 2006). Moreover, in the absence of central standards, the transaction costs in terms of contract design, awarding provisions and monitoring are high. In addition, minimum requirements regarding placement success of private providers have been set very low, close to rates at which the benefit recipients flow out even without placement

(Dykstra and de Koning, 2004). Overall, the current set-up has led to a very fragmented market with more than 1 800 providers for reintegration services of which 1 200 are self-employed. The tendering process and the incentives for the reintegration companies should therefore include not only the placement fee but also include a success criterion regarding the duration of the new job (Tergeist and Grubb, 2006). Moreover, constant evaluations of reintegration services are necessary to evaluate the effectiveness across providers with different case load characteristics. Preferably, these evaluations should take into account the past track record in terms of achieving placements, possibly using the Australian “star ratings” to provide a clear benchmark (Grubb, 2004). In addition, the UWV could follow up regularly on successfully placed job seekers to get feedback from the new employer regarding the relevance of the particular reintegration service in the hiring decision.

#### **Box 7. The market for reintegration services**

The selection of private providers has been a concern with the outplacement of reintegration services. In order to ensure the quality of these services, the SUWI Act stipulates that public institutions can only contract with service providers that operate according to certain basic quality standards.<sup>16</sup> In addition, the association of training providers (*Borea*) has developed a more elaborated quality certificate, which is granted to providers that meet 13 criteria and accept semi-annual audits and has been obtained by 72 providers (60% of the market volume). Reputation effects and the market selection mechanism are then supposed to guarantee that the most efficient providers will be selected by the UWV and the municipalities. This, however, does not seem to be the case: the market share of private providers did not evolve according to the placement success, even though some improvement in this respect seem to have been observed more recently (De Graaf-Zijl *et al.* 2005; Groot *et al.* 2006). What is more, even the *Borea*-certificate is no signal for performance as providers both with and without the certificate experienced similar reintegration success rates (De Graaf-Zijl and Groot, 2005). Moreover, while private providers seem to excel in rehabilitating groups with weak labour market attachments, they are less successful at contracting with employers and matching job seekers with unfilled vacancies. A first step to assess the contribution of different providers to reintegration success has been undertaken by the publication of purchaser satisfaction rates by the Council for Work and Income (RWI), albeit not yet on a regular basis.

#### ***Strengthening sanctions***

25. A third policy tool for reducing the high incidence of long-term unemployment is to apply sanctions in case of insufficient job search and administrative infractions. By international comparison, Dutch public employment services (PES) have a long and precise list of sanctions at their disposal, which they use consistently and to a similar degree as PES in certain other countries, such as in Switzerland and the United States (Tergeist and Grubb, 2006; Gray, 2003). In 2007, a new system of measuring job search was introduced, based on individual targets that are periodically verified by the CWI case manager. The system allows the case manager to take the economic situation into account, weakening job search obligations considerably in less favourable times for up to 6 months, when the initial definition of a suitable job is widened. International evidence suggests, however, that sanctions should be applied earlier, ideally after 3 months, together with a gradual broadening of the definition of suitable jobs – as is currently planned – and the requirement that part-time workers accept a full-time job if no alternative exists (Graversen, Damgaard and Rosdahl, 2007). Moreover, maximum commuting requirements should be widened after longer unemployment spells, as the current 1.5 hour limit in each direction is relatively restrictive when taking into account the high incidence of commuting difficulties in the densely populated parts of the Netherlands. Some countries such as Norway or Sweden even require relocation, depending on the family situation of the job seeker. Finally, proper monitoring of job search efforts requires reliable information. In this respect, it seems that fixing quantitative goals (four applications in a four-week period) has led to job seekers sending out applications regardless of their potential to satisfy the qualifications specified in the vacancy note. Moreover, some unemployed have resorted to performing poorly on purpose during job interviews. Hence, the CWI needs to strengthen its assessment regarding the quality of job applications of the benefit recipient and should follow up on job interviews more intensively by contacting employers for feedback information.

### **Box 8. Labour market participation: recommendations**

#### ***Continue activating social assistance beneficiaries***

Job search requirements for current social assistance benefit recipients should be strictly enforced. The authorities should not introduce exemptions for lone parents as is currently planned.

#### ***Encourage participation of women with weak labour market attachment***

The authorities should implement – as planned – the phase-out of the transferability of the tax credit for second earners. However, they should consider a more rapid phase-out rate than the currently announced 15 years.

Shift more of the family-income based child tax credit to the individual or second-earner children tax credit.

#### ***Consolidate the successful reforms of disability benefits***

The authorities should closely monitor the outflow of former disability benefit recipients in order to assess the success of the disability benefit reform in reintegrating them into the labour market.

Medical criteria for the young disabled under the Wajong scheme should be tightened. Preferably, the young disabled should first receive social assistance and be granted Wajong only as a top-up after a waiting period.

The authorities should continue retesting the existing stock of disabled under the new, stricter medical testing criteria, disregarding the age of the benefit recipient. Moreover, in order to allow fully and permanently disabled people to benefit from new employment opportunities, permanent disability should be re-examined on a regular basis.

New entrants into the partial disability benefit scheme should be activated early, possibly already during their sickness period. In addition, the authorities should consider further strengthening work incentives for partially disabled by shortening the initial period of the first-stage replacement benefit (the *loongerelateerde uitkering*).

#### ***Further increase participation of older workers***

The use of tax-favoured savings schemes such as the recently introduced life-course savings scheme should be monitored closely. The authorities should consider phasing-out the tax exemptions for these schemes entirely.

The job search requirements for older workers should be strengthened and aligned with those for other unemployed.

The effective exit age from the labour market needs to increase. This can be achieved by indexing the official retirement age to the increase in life expectancy. In order to allow older workers to be employed after the age of 65, permanent contracts should be made transformable into temporary ones more easily.

The obligation to pay full wages during long periods of sickness for + 65 years should be reconsidered.

In order to strengthen participation incentives for older workers, the state pension system (AOW) should be reformed and possibly merged with the current Social Assistance benefit scheme.

#### ***Further enhance activation of the long-term unemployed***

Unemployment benefits should be made more activating by further reducing benefit duration and allowing for a gradual decrease of the replacement rates with the length of the unemployment spell. This could imply an initially higher replacement rate for short unemployment durations.

In order to improve labour market dynamics and to lower long-term unemployment, employment protection should be lowered. This could be achieved by making the current dual system of dismissal simpler and more predictable. In particular, the rules governing layoffs should be clearly specified in law with appeal to local courts only possible as an ex-post option, in case one of the parties feel unfairly treated. Moreover, in order to safeguard labour market chances for workers after the age of 50, the accumulation of their severance payment rights should be aligned with that of other workers.

The unemployed should be profiled directly into different programmes instead of different activation categories. Moreover, the authorities should consider the introduction of economic incentives to allow benefit recipients to self select into different programmes.

Activation should start no later than three months after the unemployed entered the system. Moreover, the government should implement its plans to widen the definitions of suitable jobs more rapidly with the length of the unemployment spell. This should also include requirements to relocate after 1 year of unemployment, depending on family circumstances.

## Notes

1. For people aged 21 to 65. There are different assistance levels for younger and older persons.
2. In practice, lone parents with children are often not subject to job search requirements, depending on the municipality that is granting social assistance. In principle, however, every benefit recipient is expected to be available for suitable work.
3. This applies to children between 12 and 18 years old. Lower rates apply for younger children.
4. The child tax credit declines at a rate of 5.75% for a household income between EUR 28 521 and EUR 44 524.
5. For instance, the number of men aged 50-55 dropped from 90 000 to 65 000 between 2000 and 2005.
6. To strengthen incentives for municipalities to activate also young disabled people, Wajong could be granted as a top-up to Social Assistance, depending on the degree of disability and after some waiting period.
7. More generally, low old-age participation rates can be accounted for, in part, by substantially higher wealth accumulated by Dutch households – mainly in form of pension and real estate assets – which tend to lower the average exit age from the labour market (Bloemen, 2006). On the other hand, there is an offsetting cohort effect with younger generations working longer over their life-cycle than older ones.
8. Both employer and employee may agree upon a new (temporary) contract, in which case the new tenure period for severance payments starts from scratch. In cases where work is continued without a renewed contract and dismissals are brought to court in a later stage, the court normally assumes that the contracts have been renewed at the age of 65.
9. It should be noted that people who intend to use the life-course savings scheme as a top-up to unemployment benefits and severance payments lose the tax advantage.
10. This would mean raising the tax-free threshold by EUR 80 000, which equals about 210% of the average wage thus creating a similar saving flexibility as under the life-course savings scheme.
11. A 2% reduction is made on the full pension for each year spent outside the Netherlands between the age of 15 and 65.
12. Alternatively, first pillar pensions could be linked to years of contributions, allowing pensioners with longer contribution histories to receive a higher pension, while still guaranteeing a minimum pension (probably at a lower level). Such a modified system would still contain a redistributive element, which could be controlled for by a cap on either pension contributions or pension replacement rates.
13. The amount of severance pay was set at one month for every year of service with a maximum of one year salary or EUR 75 000 (or EUR 100 000 for older workers) in case the annual salary was below this income limit.
14. The proposal did provide for the possibility to have the amount of severance pay lowered by court decision in case it would jeopardise the financial health of the company. Moreover, the CWI-route would still have been available for dismissals due to business and economic reasons. In that case, no severance pay would have been paid.
15. Only very few courses are available in-house, mainly on the level of municipalities, which stopped to be obliged to outsource these services since 2006.
16. Service providers need to have a complaint procedure and a client privacy register.

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